
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Water System: 2010 Refunding Bonds

OVERVIEW

The City Council is being asked to authorize Water Refunding Bonds (Refunding Bonds) in a principal amount not to exceed \$353 million. The requested authorization provides that Refunding Bonds can be issued, in one or more series, through June 30, 2011. To the extent that interest rates in the capital markets allow, these Refunding Bonds would facilitate an economic refunding (resulting in gross and net present value debt service savings) of the outstanding Certificates of Undivided Interest – Series 1998 (1998 Certificates) and 2002 Subordinated Bonds (2002 Bonds).

Staff is requesting approval of an ordinance (authorizing the Refunding Bonds and approving related bond documents) and a resolution (approving the Bond Purchase Agreement and appointing Bond and Disclosure Counsel for the 2010A Series of the Refunding Bonds). Depending on market conditions, these actions will set the stage for one or more series of Refunding Bonds through June 30, 2011; however, staff must return to the City Council for approval of a Preliminary Official Statement (POS) for each series of Refunding Bonds before they can be sold.

This report discusses the requested forward authorization to initiate current and advance economic refundings in accordance with City Debt Policy parameters. Additionally, we comment on a question raised by Councilmember Frye regarding Council approval of bond documents prior to review/approval of the POS.

FISCAL/POLICY DISCUSSION

The requested forward authorization for Water Refunding Bonds contemplates an economic refunding of the 1998 Certificates and an advance refunding of the 2002 Bonds. As explained in the staff report, advance refunding of the 2002 Bonds is required because they are not eligible to be redeemed until August 1, 2012.

Current Refunding

As defined in the City's Debt Policy, a current refunding is one in which the refunding bonds are issued less than 90 days before the date upon which the refunded bonds (in this case, the 1998 Certificates) will be redeemed. The Debt Policy states that the City will consider current refundings when there are aggregate net present value savings, expressed as a percentage of the par amount of the refunded bonds, of 3% or higher.

Advance Refunding

As defined in the City's Debt Policy, an advance refunding is one in which the refunding bonds are issued more than 90 days prior to the date upon which the refunded bonds (in this case, the 2002 Bonds if interest rates fall) will be redeemed. Advance refundings are used to refinance outstanding debt before the date the outstanding debt becomes due or callable. Proceeds of advance refunding bonds are placed into an escrow account with a fiduciary and used to pay interest and principal on the refunded bonds and then used to redeem the refunded bonds at their maturity or call date. The Debt Policy states the City will consider advance refundings when there are aggregate net present value savings, expressed as a percentage of the par amount of the refunded bonds, of 4% or higher.

The aggregate net present value savings percentage thresholds are established to ensure there is a sufficient amount of net present value savings to warrant the time/expense of issuing refunding bonds. As advance refundings involve additional time and financing requirements (i.e., establishing an escrow account), the aggregate net present value savings percentage threshold is slightly higher.

Forward Refunding Authorization

If current interest rate levels remain unchanged until the estimated bond pricing date for Series 2010A in mid-June, staff estimates the City would only be able to refund the \$141.3 million of outstanding 1998 Certificates. As shown in Attachment 1 of the staff report, a current refunding of the 1998 Certificates results in net present value savings of 3.02% based on interest rate levels on March 17, 2010. While the estimated gross savings (\$16.5M) and net present value savings (\$4.3M) are significant, the aggregate net present value saving percentage of 3.02% just meets the City Debt Policy parameter. If rates were to increase before the anticipated bond pricing, a portion of the 1998 Certificates would have to wait for interest rates to fall before they can be refunded in accordance with the Debt Policy.

Debt Management staff has indicated interest rates would have to fall by approximately one-quarter to one-half a percent in order for some 2002 Bonds to meet the 4% net present value savings threshold for an advance refunding. Interest rates were lower in the last quarter of 2009 when the City's financing team was evaluating the feasibility of refunding the \$168.7 million of eligible/outstanding 2002 Bonds. Although interest rates have moved higher in recent months, staff recommends the City be prepared to quickly refund the outstanding water system debt should interest rates fall in the months ahead.

As economic refundings yield debt service savings that can be used to fund additional water system improvements without increasing charges for ratepayers, the IBA recommends supporting the forward refunding authorization request. If approved by the City Council, the refunding authorization is limited to the outstanding 1998 Certificates and eligible 2002 Bonds. The duration of the authorization is also limited until June 30, 2011. If interest rates were to fall making the issuance of additional Refunding Bonds feasible, staff must return to the City Council for review/approval of the POS.

City Council Process for Authorizing Bonds

Staff currently requests City Council authorization for proposed bond issuances in two steps. As with this request for Water Refunding Bond authorization, the first request typically involves an ordinance authorizing a not-to-exceed amount of bonds and approving most of the necessary bond documents. A resolution approving the Bond Purchase Agreement and appointing financial/legal consultants is also typically part of the first request for City Council approval. A second request for action usually follows a month or two later and involves City Council review/approval of the POS.

In considering recent requests for bond financing, Councilmember Frye asked if it made sense to authorize the financing and most of the necessary financing documents before reviewing/approving the POS. She asked if there were any best practices with respect to how a legislative body should approve bond financing requests. IBA Report [#10-24](#) discussed the proposed 2010A Master Refunding. The Report addressed this subject and indicated the IBA would research any best practices that might exist in this regard.

The IBA was unable to find a published best practice relating to how legislative bodies should approve bond financing requests. We inquired with other peer cities in California (Los Angeles, San Francisco, San Jose, and Long Beach) and found that these agencies typically approve all bond documents, including the POS, together close to the anticipated time of bond sale. It is important to note, however, that these jurisdictions do not have our City Charter Section 99 requirement that contracts over five years be approved by ordinance. With the exception of the POS and the Bond Purchase Agreement, the other necessary bond documents match the term of the bonds and are contracts exceeding five years.

A City ordinance authorizing long-term bond financing requires an introduction two weeks prior to subsequent City Council approval, followed by a required 30-day referendum period after which the Mayor has up to ten days to veto or approve. Allowing for lead docketing time, this process takes approximately two months. Although staff could docket all bond documents (including the POS) for a single meeting of the City Council, they have opted to delay seeking City Council approval of the POS to allow 1) time for the authorizing ordinance to become effective and 2) disclosure information within the POS to be in substantially final form closer to the time of anticipated bond sale.

The IBA understands that requesting two City Council approvals for the same financing several weeks apart may require the Council to review or re-review a proposed bond financing twice; however, given the City Charter Section 99 requirement and the need for Council to review/approve a substantially final POS closer to the anticipated time of bond sale, we believe the current process is appropriate. Alternatively, City Council could approve all bond documents at a single Council meeting with direction for staff to show all subsequent or substantive changes to the POS back to the Council prior to the sale. Unfortunately, this process would be less transparent to the public and would still require an organized process for Council feedback regarding changes to the POS.

CONCLUSION

The City Council is being asked to authorize Water Refunding Bonds in a principal amount not to exceed \$353 million. The requested authorization provides that Refunding Bonds can be issued, in one or more series, through June 30, 2011. To the extent that interest rates in the capital markets allow, these Refunding Bonds would facilitate an economic refunding resulting in gross and net present value debt service savings. As economic refundings result in debt service savings that can be used to fund additional water system improvements without increasing charges for ratepayers, the IBA recommends adoption of the proposed refunding ordinance as a resolution.

The IBA has been informed that representatives of the City's financing team will be present for the City Council meeting on April 19, 2010. The IBA encourages the City Council to ask any questions they might have directly to members of the City's financing team, including the City's financial advisor, bond and disclosure counsel, and the underwriters.

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